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July 28, 2011

TO: Supervisor Michael D. Antonovich, Mayor
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FROM: Wendy L. Watanabe Wendy L. Watanabe
Auditor-Controller

SUBJECT: **REVIEW OF COMPENSATION POLICIES OF NONPROFIT ORGANIZATIONS THAT CONTRACT WITH THE COUNTY (Board Agenda Item 4, March 15, 2011)**

On March 15, 2011, your Board instructed the Auditor-Controller to review the compensation policies of a sample of nonprofit organizations that contract with the County (nonprofits), similar to AltaMed Health Services Corporation (AltaMed). Your Board also instructed us to make recommendations regarding compensation, overhead and other issues related to these organizations, and to address incorporating federal guidelines into future County contracts.

Our review included comparing executive compensation, overhead and other financial information for a sample of 63 nonprofits that contract with the Departments of Health Services (DHS), Public Health (DPH), and Mental Health (DMH). We also contacted other counties in California to determine whether they limit contract nonprofit executive compensation, and evaluated industry and federal compensation standards/guidelines, to determine whether the County should adopt similar requirements.

Review Summary

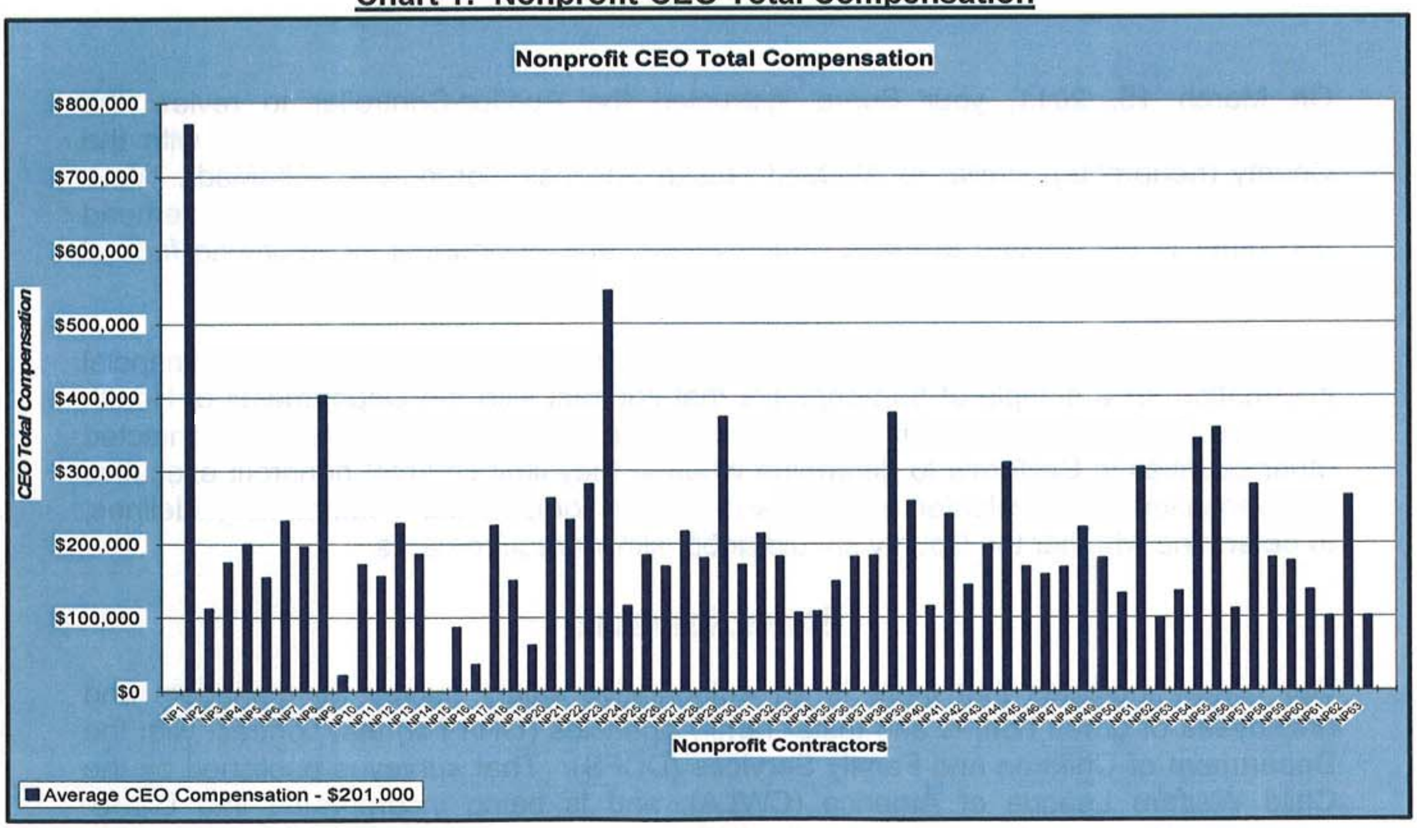
Our review indicates that there is an authoritative salary survey for managers and employees of group homes and foster family agencies (GH/FFA) that contract with the Department of Children and Family Services (DCFS). That survey is published by the Child Welfare League of America (CWLA), and is being incorporated into DCFS' contracts. However, there are no authoritative surveys or specific criteria for executive compensation and overhead that can be applied to all the nonprofits, such as AltaMed, that contract with DHS, DPH, DMH, and other County departments. Because there are no specific criteria that can be used to set compensation/overhead limits for all nonprofits that contract with the County (other than GH/FFAs), and because setting salaries is generally the responsibility of the nonprofits' boards of directors, we do not believe the County should set specific guidelines or limits for nonprofit agency salaries. Instead of setting guidelines or limits, we recommend that County departments should consider requiring all nonprofits to disclose their salary and overhead information in their contract proposals. County departments can then review the information before awarding a contract, identify any agencies with high compensation and/or overhead, obtain an explanation from the agencies, and determine whether there is sufficient justification for the County to contract with an agency with high compensation/overhead.

Details of our review and recommendations are discussed below.

Compensation Analysis

We obtained chief executive officer (nonprofit-CEO) total compensation (including base salaries, bonuses, retirement contributions, etc.) and other financial information from a sample of 63 nonprofits that contract with DHS, DPH and DMH, including AltaMed. As noted in the following chart below, there are significant variations among the nonprofit agencies' CEO compensation.

Chart 1: Nonprofit-CEO Total Compensation



As noted in Chart 1, total nonprofit-CEO compensation for the 63 nonprofits ranged from $0 (i.e., the nonprofit-CEO provides services in exchange for in-kind benefits) to $770,000, with an average of approximately $201,000.

We also compared the total nonprofit-CEO compensation to their total annual County contract amounts, and to the agencies' total operating revenue. As noted in Charts 2 and 3 below, our comparison indicates that, in most cases, there is a general relationship between the nonprofit-CEOs' compensation and the agencies' County contracts and/or their total revenue. For example, the agency with the highest annual revenue also has second highest nonprofit-CEO compensation. However, one agency's nonprofit-CEO's compensation is significantly higher than other agencies in our sample.

Chart 2: Nonprofit-CEO Total Compensation and Annual County Contracts

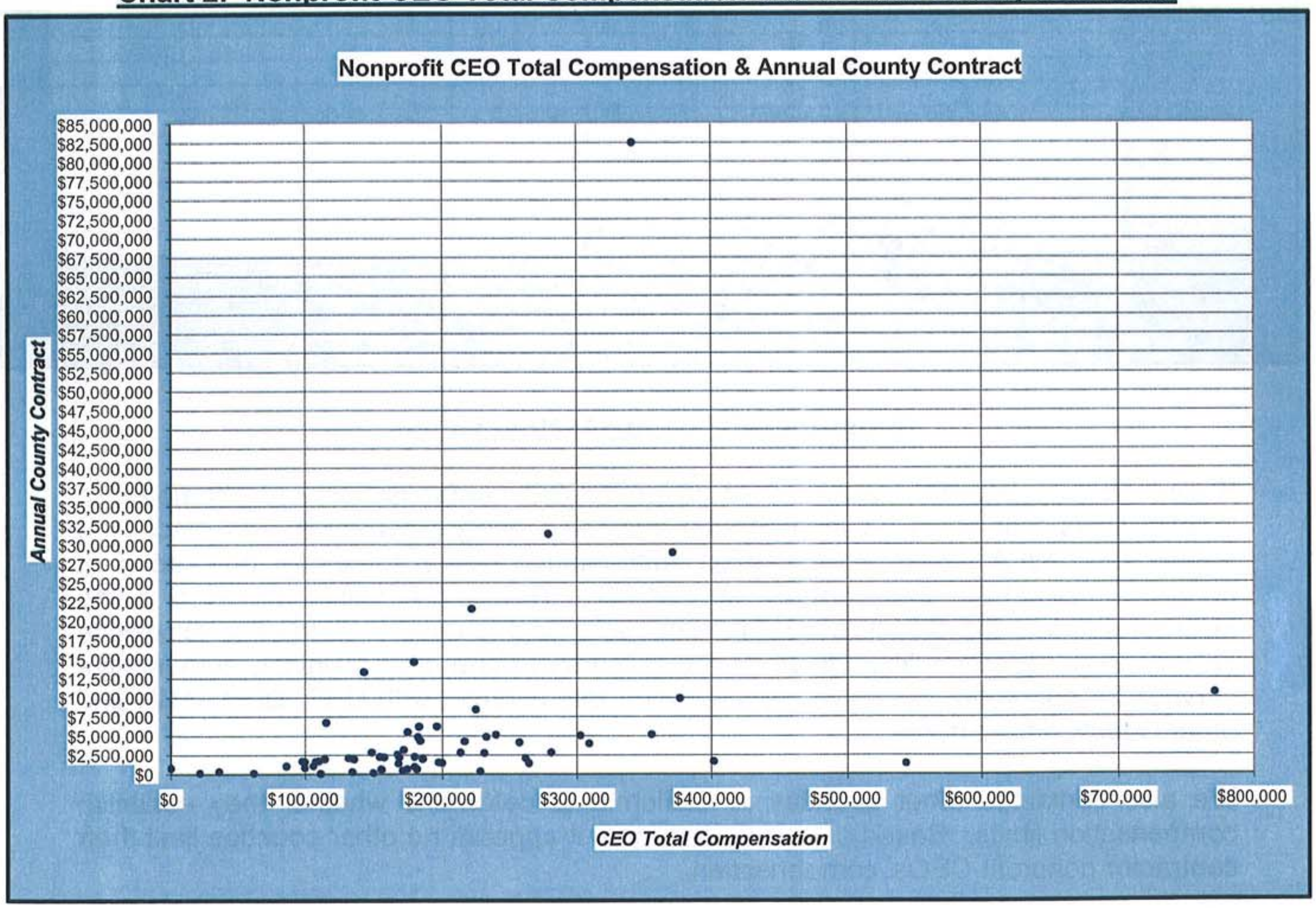
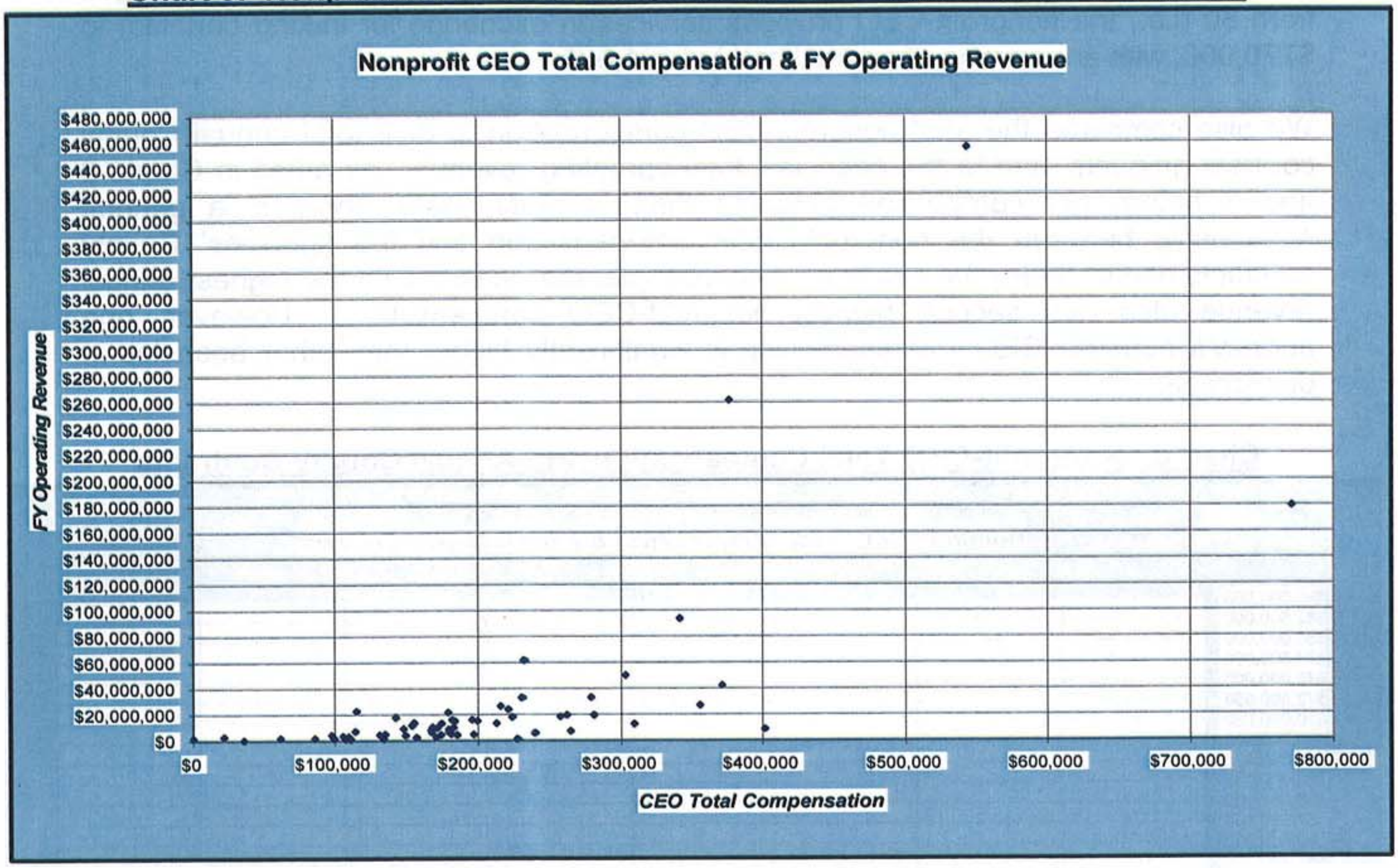


Chart 3: Nonprofit-CEO Total Compensation and Total Operating Revenue



Nonprofit-CEO Compensation Limits

Based on your Board's concern over nonprofit-CEO compensation, we attempted to identify limits that could be incorporated into the County's contracts. As discussed earlier, the CWLA issues a recognized, authoritative salary survey for one group of nonprofits; GH/FFAs, that contract with DCFS. The CWLA salary survey is being incorporated into the County's GH/FFA contracts, and is used to determine excessive salaries in our fiscal audits. However, we noted that there are no similar, authoritative surveys for nonprofits executive compensation that contract with DHS, DPH, DMH and other County departments.

We also contacted other counties in California to determine whether they establish compensation limits. Based on our discussions, it appears no other counties limit their contractor nonprofit-CEOs' compensation.

We did note that the federal National Institutes of Health (NIH) has a salary limit that could apply to these nonprofits. The NIH limits the base salary that can be charged to an NIH grant/contract to $199,700 for federal Fiscal Year 2010. However, this limit does not restrict how much a nonprofit-CEO (or other person) can actually be paid, it only limits how much compensation can be charged to an individual NIH grant/contract.

In 2008, the federal Internal Revenue Service (IRS) established reporting requirements to identify potentially unreasonable compensation for nonprofit board members, trustees, officers and key employees. The IRS did not set specific compensation limits. However, if the IRS determines that a salary is potentially "unreasonable", it will ask for information regarding the independence of the agency's board that established the salary to ensure that the salary was set by people independent of the nonprofit-CEO. The IRS will also ask about the data the agency used to set the salary (e.g., salaries paid by comparable agencies, etc.) and the adequacy of the documentation on how the salary was set. If the salary is unreasonable based on this "three-pronged test", the IRS may impose sanctions, including imposing excise taxes on any unreasonable salaries, up to and including revoking an entity's non-profit status.

Given the lack of authoritative surveys or specific criteria for executive compensation (other than GH/FFAs), it would be difficult for the County to impose strict limits on executive compensation for contract nonprofit agencies. In addition, setting agency employee salaries is the responsibility of the nonprofits' boards of directors, and County limits might impact the agencies' independence and ability to hire/retain staff. Finally, County departments may determine that there is sufficient justification for the County to contract with an agency, regardless of their compensation practices. For example, if a nonprofit agency provides high-quality or hard-to-find services to an underserved geographic area or population, a County department may decide to contract with that agency, regardless of their compensation practices.

Recommendations

While we do not believe it is feasible for the County to set specific limits on nonprofit compensation (except for GH/FFAs), we recommend that County departments should consider requiring all nonprofit agencies to provide greater disclosure of their compensation practices before contracts are awarded. County departments could then review agencies with compensation amounts over the NIH limit, including looking at how much of the compensation is attributable to County funds. County departments should also consider requiring agencies to report any significant increases in executive compensation throughout the term of their contracts. The following are our detailed recommendations:

- **Consider requiring nonprofits to provide additional disclosure of executive compensation.** County departments should consider requiring all nonprofit agencies to include the names, base and total compensation of their officers, directors and key employees in their proposals to the County. This is the same information the agencies report in their IRS 990 Forms, which are public documents. This will allow the County departments to review each agency's executive pay and address any concerns before awarding a contract.

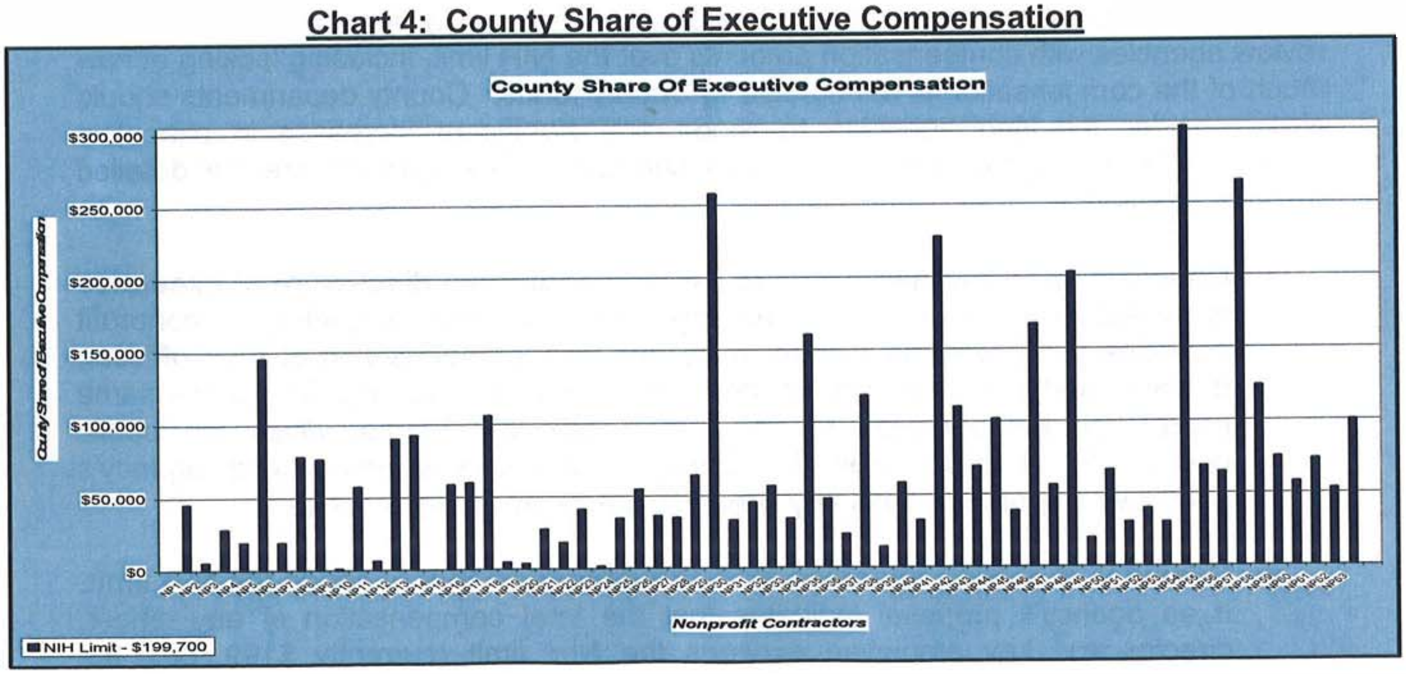
- **Consider reviewing agencies with compensation that exceeds the NIH limit.** If an agency's proposal indicates that the total compensation of any officer, director and key employee exceeds the NIH limit (currently $199,700), the department should consider asking the agency to provide information on the how the salary was determined, whether the approval was done by independent Board members, what data was used to set the salary (e.g., salaries for comparable agencies) and the documentation for the salary determination.

- **Compare County's share of executive compensation.** County departments should consider requiring agencies to provide the total annual amount of all their County contracts (including the contract for which they are submitting the proposal) and the agency's total operating revenue in their proposals. Agencies could also provide the percentage of annual County revenue to their total operating revenue (i.e., total County contract amount divided by total annual revenue), and apply that percentage to their highest paid employees' total compensation to compute the amount of executive pay that can be attributed to County funds.

$$\frac{\text{Total Annual County Contracts}}{\text{Total Annual Operating Revenue}} \times \text{Executive Total Compensation} = \text{County Share of Executive Compensation}$$

As noted in Chart 4 below, in most cases, the County's share of most agencies' total revenue is relatively small, so the amount of compensation attributed to the County contracts will be relatively low. For example, for the agency with the highest nonprofit-CEO compensation of the nonprofits reviewed ($770,575), the County only accounts for approximately 6% of that agency's total revenue. So only about $46,000 of the nonprofit-CEO's salary (6% of $770,575) can be attributed to the Agency's County contracts. However, in cases where a significant amount of a nonprofit-CEO's compensation is attributed to County funds, departments should carefully consider evaluating whether there is sufficient justification for the County to contribute that much to an agency's nonprofit-CEO's compensation.

Chart 4: County Share of Executive Compensation



By requiring the added disclosure and evaluating the agencies' compensation before awarding contracts, the County will have more information to identify and question potential compensation issues, and make more informed contracting decisions.

As discussed earlier, this approach does not set strict limits on agency compensation, or include agency salaries in scoring the proposals. Instead, it allows departments to review agency compensation practices, how the compensation amounts were established, how they compare to other agencies, and how much can be attributed to County contracts. Departments can then use that information, along with the County's goal of obtaining needed services from the best, most cost effective agencies, to decide whether there is sufficient justification to contract with an agency with high compensation. Departments can expedite this process by contacting other County departments who have contracts with the same agency, and using prior compensation reviews. For example, if DHS, DPH and DMH all have contracts with one agency, only one of the departments would need to evaluate the agency's compensation practices. This would avoid having multiple departments reviewing the same agency's compensation.

Application to Current Sample

In our current analysis, 23 of the 63 (37%) nonprofits exceeded the NIH compensation limit, and would need to be reviewed by departments that awarded contracts to them. The respective Departments should review these agencies' executive compensation for reasonableness and determine if contracting with these agencies is appropriate.

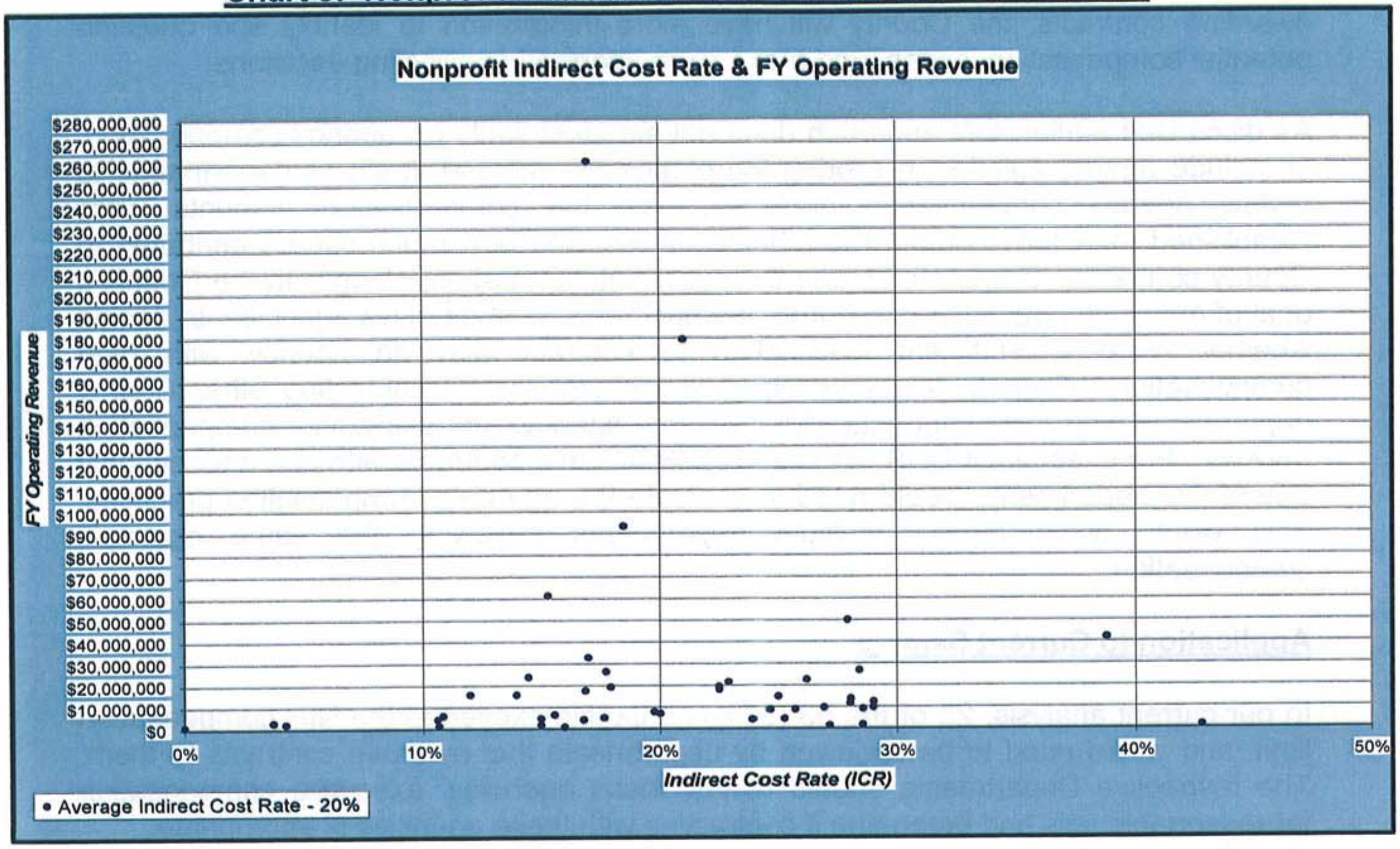
Ongoing Reporting

Department contracts with nonprofits should also consider including a requirement that the agencies notify the County departments if the agencies plan to increase a key executive's base/total compensation by more than a set percentage (e.g., 10%). This will allow the County to monitor increases in compensation which may affect the County's contracting decisions on an ongoing basis.

Nonprofit Agency Overhead

The Board also asked us to review the nonprofit agencies' overhead. Forty-six of the 63 (73%) agencies provided their indirect cost (overhead) rate. As noted on the chart below, the nonprofits' average overhead rate is approximately 20%.

Chart 5: Nonprofit Indirect Cost Rate and Operating Revenue



Similar to the issues noted with salaries, we have not identified any governmental limits or industry standards that could be used to set specific limits on nonprofit agency overhead.

We recommend that County departments use the same approach with nonprofit agency overhead, as we have recommended with executive compensation. Specifically, departments should consider requiring the agencies to disclose their overhead rate in their proposals. County departments can then follow up with any agencies whose overhead rates seem excessive, and determine whether there is sufficient justification for the County to contract with an agency with a high overhead rate.

Conclusion

Our recommendations for departments to evaluate compensation and overhead do not include using compensation/overhead information to score proposals. We believe that setting specific limits for compensation or overhead for these agencies, or using compensation/overhead to score proposals would be arbitrary, and could prevent departments from contracting for essential services with high quality agencies.

To avoid this, we are recommending that departments consider obtaining agency compensation/overhead as part of the solicitation process, and using guidelines to be developed, determine whether the compensation/overhead is "high" and, if so, whether there is sufficient justification for the County to contract with an agency with "high" compensation/overhead. The departments could present this information to your Board when making contract award recommendations.

In addition, it is important to note that some nonprofit agencies are paid under fee-for-service contracts, where the agency agrees to accept a flat fee for specific services. However, regardless of the type of contract, County departments could still conduct compensation/overhead assessments as described above. While this information gathering and analysis will create some additional workload for departments, this data is necessary for the Board to make future policy decisions regarding non profit executive compensation. We have discussed this approach with County Counsel and the Internal Services Department (ISD), and we are available to assist departments to ensure that this process results in fair and consistent analyses.

Review of Report

We discussed the results of our review with County Counsel, ISD, and the departments that contract with the agencies. They are in general agreement with our recommendations for reviewing executive compensation and overhead, but expressed concerns about the additional workload required to collect and analyze this data from fee-for-service contractors. We will continue to work with departments and provide further assistance in this area.

We would like to thank DHS, DPH and DMH management and staff, and the nonprofit organizations that took part in our review for their cooperation and assistance.

Please call me if you have any questions, or your staff may call Jim Schneiderman at (213) 974-8303.

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